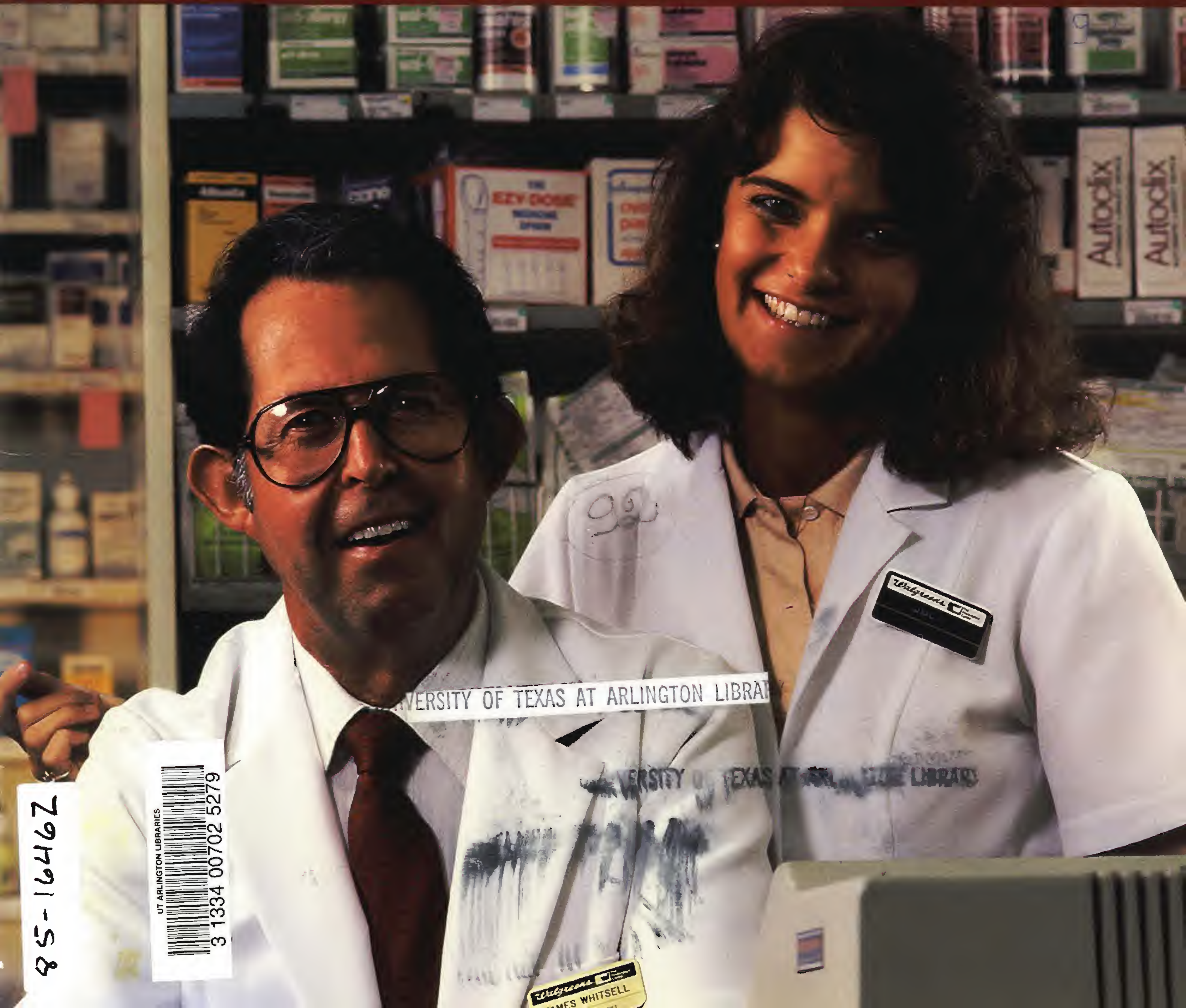
Walgreens Annual Report 1985 **Focus On Pharmacy**



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Cover:
Chief pharmacist Jim Whitsell with pharmacy technician Juli Moody, 6680 Poplar, Memphis. Jim, a 25-year Walgreen employee, has worked at this store since it opened in 1976. "Stability among our pharmacists is a Walgreen strength," explains Bill Thien, vice president, Health Services. "Customer loyalties are built on the rapport and trust which our pharmacists instill. We encourage the attitude — 'This is my store, these are my customers.'"

The Walgreen Company

Walgreen Co., an industry leader with annual sales of $3.16 billion, operates drugstores and restaurants in 28 states and Puerto Rico. Founded in 1901, it has 36,000 employees and 18,380 shareholders.

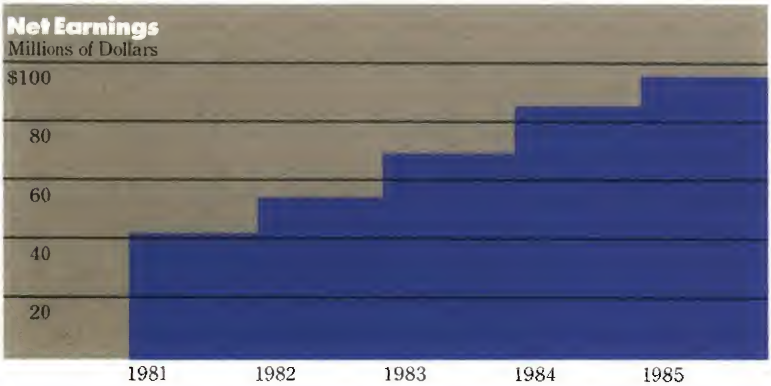
The retailer's major activity consists of 1,095 drugstores, serving more than one million customers a day, and averaging $2.8 million in annual sales per unit. Integral to store operations are Walgreens five major distribution centers, a full-case warehouse, and four photo-processing studios. The company manufactures and packages more than 400 private label health and beauty items.

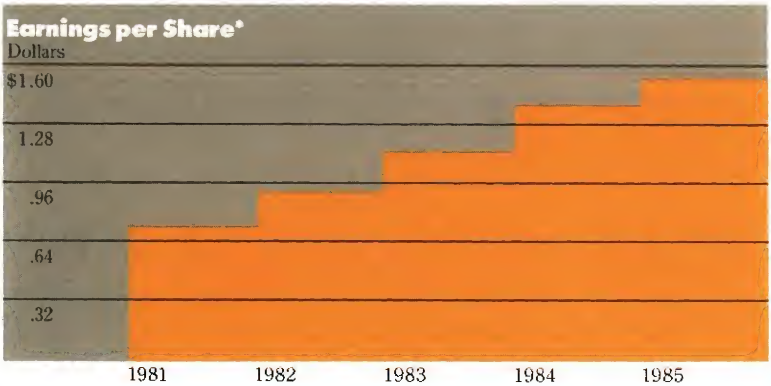
Walgreens also operates 87 in-store food units and 94 separately located restaurants, including 70 free-standing Wag's family restaurants in Florida and the Chicago area. The chain is parent to International Travel Service, a Chicago-based subsidiary specializing in group travel.

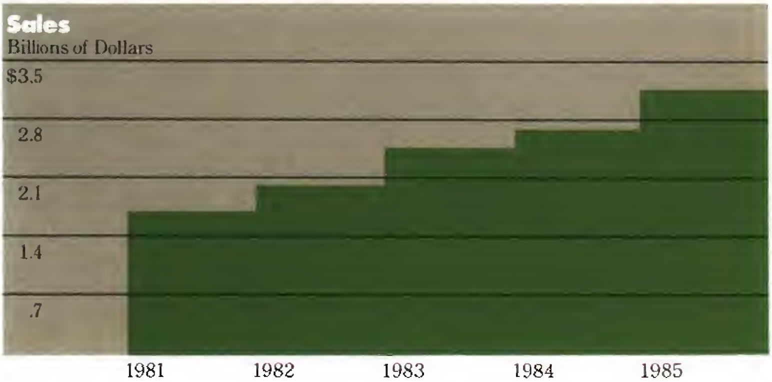
Walgreen Co. is dedicated to a progressive growth philosophy guided by a conservative fiscal policy. Dividends, paid in every quarter since 1933, have been raised 11 times in the last eight years.

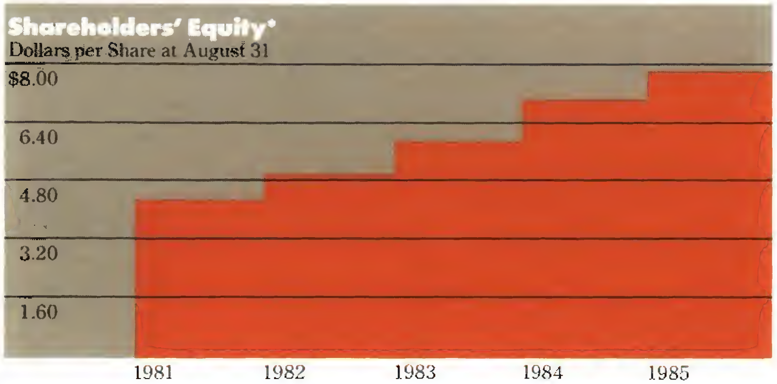
Health care is the cornerstone of Walgreens business…the pharmacy customer is our most important. Walgreens has the leading pharmacy computer system in the industry. But our real edge is personal service…provided by individual pharmacists in more than a thousand stores. This report recognizes their commitment to both the profession and their customers.

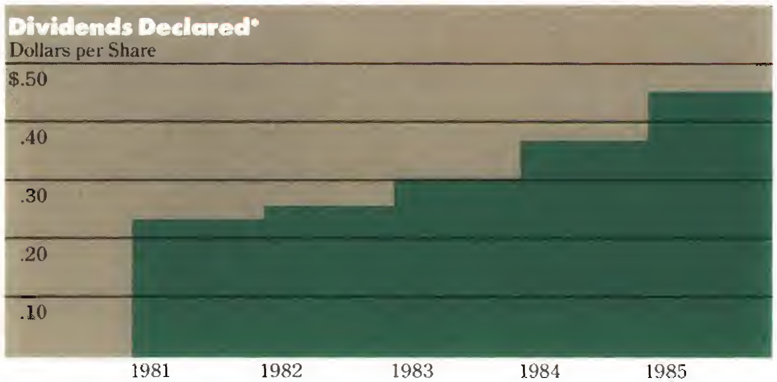
Financial Charts

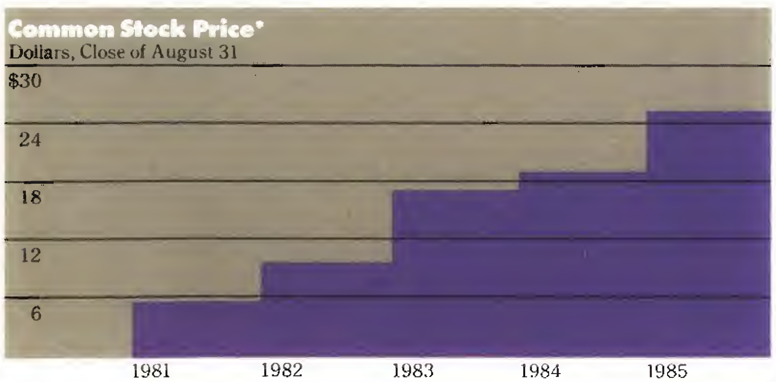












**Per share data have been adjusted for two-for-one stock splits effective in January of 1982 and 1983 and in April of 1985.*

Financial Highlights

(Dollars in Thousands, except per share data)	1985	1984	% Increase
Net Sales	$3,161,935	$2,744,625	15.2
Earnings from U.S. operations before income taxes	173,700	149,983	
Income taxes	79,531	69,340	
Earnings from U.S. operations	94,169	80,643	16.8
Equity earnings	—	1,205	
Gain on sale of equity investments in Mexican operations, net of income taxes	—	3,598	
Net Earnings	$ 94,169	$ 85,446	10.2
Net Earnings per Share	$ 1.53	$ 1.39	10.1
Shareholders' Equity	$ 480,974	$ 414,618	16.0
Return on Average Shareholders' Equity	21.0%	22.3%	

Dividend and Market History, Fiscal 1985 and 1984

3 Months through:	Dividends Declared 1985	Dividends Declared 1984	Common Stock Prices 1985 High	Common Stock Prices 1985 Low	Common Stock Prices 1984 High	Common Stock Prices 1984 Low
November	$ .11	$ .09	$\$22\frac{7}{16}$	$\$18\frac{3}{4}$	$\$20\frac{3}{16}$	$\$16\frac{9}{16}$
February	.11	.09	$27\frac{5}{16}$	$20\frac{15}{16}$	$20\frac{1}{8}$	$15\frac{9}{16}$
May	.11	.09	$28\frac{7}{8}$	$24\frac{1}{8}$	$18\frac{1}{8}$	$14\frac{5}{16}$
August	.11	.09	$30\frac{1}{8}$	23	21	$15\frac{1}{8}$
Fiscal Year	$ .44	$ .36	$\$30\frac{1}{8}$	$\$18\frac{3}{4}$	$21	$\$14\frac{5}{16}$

Per share data have been adjusted for the two-for-one stock split effective in April of 1985.

Charles R. Walgreen III *Fred F. Canning*

We combined a vigorous expansion year with another record year of sales and earnings for Walgreen Co. in fiscal 1985. It was our 11th consecutive year of record sales and earnings.

Sales for the fiscal year topped $3 billion for the first time, advancing 15.2% to $3.16 billion. Net earnings rose 10.2% to $94,169,000. Last year's earnings had benefited from a non-recurring gain of $3.6 million from the sale of our Mexican affiliate, Sanborns. Earnings per share this year were up 14¢, to $1.53 per share.

The ongoing strength of the drugstore business is indicated by earnings from U.S. operations, which were up 16.8% for the year.

Expansion.

The company accelerated its expansion program, opening a record 106 drugstores during the year, as well as doing major remodelings of 61 stores, and opening nine free-standing Wag's restaurants.

This aggressive store opening pace affects near-term profits, but it also gives us stronger market penetration and economies, and positions us for long-term growth. The new drugstores strengthened the Walgreen presence in virtually all our major markets.

The Drug Store Division performed very well, registering a 15.8% sales gain. This increase represents real sales growth, with sales in comparable stores (stores opened at least one full year) increasing 8.5% for the year.

Food Services' sales were up slightly, but earnings were less than expected. We plan to open seven free-standing Wag's in fiscal 1986, and will continue to close marginal in-store units, typically remodeling them into drugstore self-service space.

Drugstore sales were spearheaded by a 26% increase in prescription sales. The professionalism of our pharmacists, combined with our advanced computer pharmacy system and increased emphasis on pharmacy, aided this advance.

Prescriptions.

Our prescription advances reflect both the reality and the potential of the health care market, which is enormous and growing. Americans spent approximately $400 billion, or 10.9% of GNP, for health care in 1984. Projections see this figure doubling by 1990, accounting for 11.6% of GNP.

The increase in births, the aging of our population, the introduction of numerous new drugs and increased self-medication, the growth of generics, and the demand for optimum quality and quick service, are all factors very favorable to our business both near and long-term. We anticipate reaching $1 billion in prescription sales alone by 1988.

We plan to open more than 120 new drugstores, including 26 acquired stores, and do 70 major remodels in fiscal 1986. Capital expenditures for the year are projected at $120 million, which will include expansion of our distribution centers at Orlando (140,000 sq. ft.); Windsor, WI (100,000 sq. ft.); and Houston (130,000 sq. ft.). These additions will help maintain fast, two-day delivery to the stores, while we continue our aggressive expansion program.

The company's balance sheet and financial position are strong, permitting us to expand with internally generated funds.

We reduced selling, occupancy and administration expenses again in 1985, to 25% of sales, below both 1984 and 1983 levels. U.S. return on sales, at 3% for the year, also improved from last year, indicating our commitment to productivity, firm controls, and optimum use of technology throughout the company.

We operate in a rapidly changing and competitive retail environment. Nonetheless, we approach the years ahead with confidence, determined to maintain our advantages in merchandising, in distribution and store technology, in store locations and shopping convenience, in customer service, and in management acumen at all levels of the company.

We will aggressively yet carefully evaluate expansion opportunities, including quality acquisitions.

Basic merchandise.

Drugstores carry literally thousands of everyday, consumable, necessity-type items, making our industry one of the most stable and recession-resistant. The American consumer wants our kind of merchandise. She will buy it at the most convenient, appealing and 'priced-right' location possible. We are pledged to make that location, wherever we can, a Walgreens.

Walter E. Cohen and William C. Musham are retiring as Directors at the end of the year. They have made noteworthy contributions to the success of the company, and we will miss their dedication and counsel.

The Board of Directors again voted a dividend increase. The December quarterly dividend will be 12½¢ per share, up 13.6% from 11¢, for an annual rate of 50¢ per share.

Supported by the expertise, enthusiasm and hard work of our fine employees, we anticipate another record year for Walgreens in 1986.

Sincerely,

C.R. Walgreen III
Chairman

F. F. Canning
President

November 25, 1985

Walgreens fundamental strength lies in a clearly focused objective: to expand its role as a convenient, customer-driven, nationwide health care retailer.

In the mid-1970s, top management committed human and financial resources to the growth and improvement of its drugstores. The results? Eleven straight years of record sales and earnings, the best 10-year earnings growth record of all major drugstore chains, and store productivity in sales per square foot well above the industry average. Walgreens today is a predictable force among U.S. retailers, recognized for consistency in both financial performance and customer service.

Sound strategies, experienced management, and an excellent financial position will allow the company to take full advantage of chain drugstore opportunities into the 1990s. To be sure, competition has intensified in recent years and industry results have been mixed. Walgreens ability to succeed and grow in this environment is based on systems and planning already in place.

The job ahead is to continually refine a proven concept. In the pages which follow, we detail our strategies for the future.

Photo—Carmen Piñeiro (far right), chief pharmacist at Walgreens Plaza Rio Hondo store in Bayamon, Puerto Rico, talks with pharmacy students at her alma mater, the University of Puerto Rico. Carmen teaches the practical side of retail pharmacy to student interns assigned to her store as part of their academic program.

"Selection standards for preceptors are stiff, so I was very pleased to be considered," she explains. "And it's quite an honor for Walgreens, too—the University selects only the best community pharmacies." Throughout the United States, more than 100 Walgreen pharmacists act as preceptors for 20 schools of pharmacy.

Expand aggressively.

Walgreens will open more stores in fiscal 1986 than at any time in its 84-year history. More than 100 new locations are planned, in addition to 26 Ribordy drugstores in northern Indiana acquired this fall. New stores in fiscal 1985 numbered 106, bringing the year-end total to 1,095. Thirty-one of these are 24-hour stores.

Quality acquisitions are very important to growth, particularly large ones which provide a strong foothold in a new market with room for further Walgreen penetration. "We are *very* serious in our quest for acquisitions of all sizes," emphasizes Senior Vice President and Treasurer Dan Jorndt.

Expansion will continue in virtually all existing markets, most heavily in Florida, California, the Southwest and Midwest. Optimum penetration maximizes profits because of efficiencies realized in management, overhead costs, distribution and advertising. Individual markets targeted for significant penetration include Oakland, Phoenix, Austin, Minneapolis, St. Louis and Tampa/St. Petersburg. Four stores will also open this year in New York City, where performance of the two units opened in 1984 improved last year.

Walgreens has earned the #1 or #2 market share in 29 of its top 36 markets. As consolidation in the industry continues—chain drug sales rose from 54 percent of all drugstore sales in 1980 to nearly 60 percent in 1984—Walgreens share of its markets should continue to rise.

"Our expansion is self-driven," explains President Fred Canning. "We don't base plans only on where development is taking place... we decide where a store is needed, then seek the best site available, whether it's an existing building, an empty lot, or a proposed strip center. The demands we make on a site for potential performance are *strict*... but our use of real estate is very *flexible*. We 'tailor' stores to fit their neighborhoods." Adds Vice President Bill Shank, "Local municipalities generally view a new Walgreen store very positively—as a desirable retailer to attract to their shopping districts."

Free-standing Wag's 24-hour restaurants will continue to grow in 1986, with seven units planned for Florida and the Chicago area. Nine Wag's were added in 1985, bringing the total to 70.

Stores must be convenient.

Walgreens dictates convenience as the most important requirement in both site selection and store layout...and the best defense against deep discounters and large mass retailers. "Price may draw the public to a new deep discounter initially, or for infrequent shopping trips," says Canning. "Certainly we must remain price competitive. But day in, day out, people return to their neighborhood drugstore for prescriptions, photofinishing, a carton of milk, a birthday card. Our size allows us to locate where our customers live and work... our experience tells us that's also where they shop."

The challenge, explains Bill Shiel, vice president of facilities development, is not only in new stores. "We must constantly reposition ourselves...keep close tabs on existing markets. Neighborhoods change, old assumptions are invalidated, the 'right' corner for the '60s is wrong in 1986. We use our research capabilities to spot shifting trends, to locate our stores for the future, to make changes when necessary."

Walgreens invests heavily in remodeling to keep stores contemporary and convenient *inside*. Fifty Walgreens plus acquired Ribordy stores face major renovation during 1986; 61 units were remodeled last year. Stores must be clean, fresh, easy to shop. "We take proven winners and keep them that way," says Shiel.

Emphasize health care.

Walgreen pharmacists fill more than 3 percent of prescriptions dispensed in the U.S., and the pharmacy customer is the company's most important. "More than any area, pharmacy sets us apart from other retailers," emphasizes Chairman Charles R. Walgreen III. "We have a strong health care franchise, built over 80 years. We're proud of the attention we've paid—and will continue to pay—to pharmacy."

Prescriptions are Walgreens number one product area, accounting for 20 percent of company sales volume in 1985, up from 15 percent five years ago. Prescription sales increases last year were 26 percent—more than double the 9 percent inflation rate for prescription drugs—and continue a trend that has led the industry since 1982.

Walgreens is also the leader in pharmacy computerization. Its on-line Intercom system has been chainwide for two years, allowing pharmacists to provide better, faster service and more time for customer contact. Prescription records are readily accessible for health, tax or insurance reasons, and refills may be electronically transferred between Walgreen stores where state law allows.

Intercom is particularly important to public and private insurance plans and health maintenance organizations (HMOs) which contract with Walgreens for prescription service. "We have the technology to handle paperwork electronically and provide detailed drug utilization reports," explains Glenn Kraiss, senior vice president of store operations. "Our sophistication in third-party prescription plans is unequalled."

Cost-conscious individual customers also benefit. Intercom automatically alerts a pharmacist to generic availability on any prescription, and then prints the savings—or possible savings—on the customer's receipt. Fifty of the 100 top-selling prescription drugs in the U.S. are now available as generics.

With consumer savings as high as 50 percent, generic drug sales are expected to climb rapidly, reaching a predicted $7.5 billion by 1990, or 37.5 percent of the total drug market. "Generics," explains Vice President of Health Services Bill Thien, "are a win-win situation—offering consumers a quality product at considerable savings."

Brand name prescription sales, meanwhile, will benefit from the introduction of several drugs currently awaiting FDA approval. And proprietary drug sales are increasing with the conversion from prescription to over-the-counter status of such popular cough/cold/allergy products as Dimetapp, Benadryl and Actifed.

Sales of incontinence supplies, diagnostic products, and other home care items are also up. "More and more patients are being discharged early from hospitals due to cost containment efforts," explains Kraiss. "They often need sophisticated products to continue care at home. In response, manufacturers are packaging traditional hospital care products for retail sale—items like post-surgical gauze pads and sponges."

The home care category is expected to expand in most Walgreen drugstores. In addition, the company will open two home medical centers in Chicago this year, bringing the total to five.

Maintain leadership in use of technology.

"The microcomputers we're planning for the stores today are more powerful than our largest computer at headquarters 10 years ago," notes Chuck Hunter, executive vice president. "And 10 years from now, we'll be using those computers in ways we've never dreamed!"

Throughout Walgreens, technology is reducing costs, providing valuable information, and improving service to stores and customers.

Stores. By the early 1990s, WIN microcomputers (part of the Walgreen Information Network) will be installed chainwide, linking all Walgreen stores, offices and other locations. WIN's initial capabilities include cash management and store payroll. A bank card authorization system will be in place by 1987, saving a projected $3 million annually in reduced bank charge fees.

Point-of-sale scanning is also under evaluation. "Certainly we see scanning as a productivity tool at store level," says Hunter. "But more important will be the scanners' ability to capture very detailed sales, profit and advertising information."

Photo—Dennis O'Dell, R.Ph. (left), Intercom pharmacy operations manager, meets with John Pyrczak, director of retail systems development, at Walgreens computer center in Chicago's northern suburbs. The on-line Intercom system is the largest and most advanced in the industry and has contributed significantly to pharmacy productivity and customer service. Future capabilities include tracking patient compliance with physician instructions, alerting pharmacists to interactions, and reviewing drug utilization for better customer cost containment.

In the background, Chicago-area pharmacists tour the computer facility, which provides central power and information storage for both Intercom and the company's new WIN store administration system. Over one million transactions a day pass through this "nerve center."

"Scanning technology is in a period of rapid development," explains John Gleeson, director of planning and research. "What's out there now is right for the food chains . . . but our needs are broader, our information demands more intense. We *know* how much scanning can do for us in the future, and we're ready to jump in when we see the equipment capabilities we need."

Distribution. Investments in new facilities and computerized systems continue to yield cost benefits. Over the last five years, distribution *volume* to stores has risen twice as fast as distribution *costs,* says Senior Vice President John Brown. Service has also reached near-optimum levels: 97 percent of all stores now receive merchandise within two days of order placement. Distribution improvements have been particularly important to pharmacy efficiency, with 90 percent of all prescription drugs now moving through Walgreens own distribution system.

Five distribution centers (in Memphis, Houston, Flagstaff, Orlando, and Windsor, WI) are equipped with the latest computer-supported systems. In the next year, warehouse space will be added in Orlando (140,000 square feet), Windsor (100,000), and Houston (130,000). A full-case warehouse in Berkeley, IL, and five public warehouses support the five full-line company-run facilities.

Photo—Bill Poe (right), pharmacy supervisor for stores in the St. Louis West District, explains Walgreens 24-hour service to Raymond Slavin, M.D., an allergist affiliated with St. Louis University's Medical School.

"Communicating with the medical community is part of my job," says Bill. "It's important that doctors feel comfortable with Walgreens, that they don't hesitate to pick up the phone and call me if there's a question. I stress that our three round-the-clock stores in St. Louis serve not only customers, but also physicians who need a prescription record in an emergency. No matter which Walgreen pharmacy a patient uses, his prescription profile can be accessed by the Intercom computer, even in the middle of the night. All it takes is a call to a 24-hour pharmacy or our 800-number hotline."

Manufacturing. A computer-supported inventory control system called MRP is revolutionizing management methods in the manufacturing area. MRP reduces raw material inventory investments, improves scheduling and shortens lead time for finished goods. Walgreens manufactures approximately 400 health and beauty items.

Store design. Push a button in Walgreens Facilities Planning Department, and a basic space plan design for a specific store location is drawn in 45 seconds. "Our computer use has been very much refined over the last five years," explains department director Tom Bergseth. "We keep Walgreen store interiors as standard as possible, but every site is unique from an architectural and engineering standpoint. We never build exactly the same store twice.

"With the computer, we move key departments around electronically . . . see our options for entrances, exits, cash register placement . . . know exactly what fixture components are needed, right down to the nuts and bolts. It's a great aid to our staff in dealing with the accelerated expansion and remodeling schedule."

Advertising. Computers control costs, measure results, and perform scheduling for Walgreen advertising. In 1986, the chain will run 33 major national newspaper inserts—each reaching 18 million American households—plus Sunday comic page wraparounds in 21 cities, and locally customized newspaper sections in 100 individual markets. Television and radio advertising will continue to increase substantially this year, still concentrating on pharmacy, photofinishing and Wag's restaurants.

Improve profit margins through tighter controls.

Competitive pressures will keep gross profit margins fairly constant during the next year, predicts Senior Vice President Dan Jorndt. "Our bottom line improvements will come from increased productivity due to labor-saving technology, control of inventory and expense, and the benefits of expansion in our major markets." Vice President of Administration Al Crotty reports that selling, occupancy and administration expenses as a percent of sales have continued to decrease each year.

Take care of the customer.

"Customer service at Walgreens isn't 36,000 employees helping millions of customers a year," emphasizes Senior Vice President Glenn Kraiss. "It's *one* clerk doing a great job for *one* customer." A new employee recognition program called "Heads Up" is designed to reward excellent service by individual employees. "You can't overstate the value of high customer sensitivity," adds Kraiss. "It goes without saying that Walgreen stores must be conveniently located and reasonably priced, but superior service is what really wins customer loyalty."

Customer sensitivity covers more than personal relationships. "It's *everything* in a store," says Kraiss. "Fast-moving checkout lines, acceptance of charge cards, backing our promotions, getting new items on a timely basis, making it easy to find merchandise, offering clerk service in cosmetics and camera. We're not perfect, but we try to be...and if a customer *does* have a problem, our goal is to solve it fast."

Walgreens merchandise mix is also customer-driven. "Shopper convenience is the constant guide," explains Vern Brunner, senior vice president of marketing. "Our stores are compact—on the average about 10,000 square feet of sales area. That means people can get in and out fast...find what they need without hassle."

"We want to be comprehensive in traditional drugstore categories—health care, cosmetics, photofinishing, greeting cards," says Brunner. "Complete convenience food sections are part of 166 stores, and we sell the basic milk, bread, chips, ice cream items in almost every Walgreens.

"But—by design—we've trimmed down our sundry merchandise over the last several years. Take small appliances—today you'll ordinarily find a few top-selling steam irons, not a selection of 20... housewares—we'll have one dishdrainer in white or beige, not a rainbow selection... toys—look for basic, high-turn, national brand products like traditional board games, Hot Wheel cars and the popular new Gobots.

"We're a *drugstore,* not a Toys 'R' Us or K mart. Our success is the result of carving our retail niche... recognizing the needs of our customers and meeting them."

Hire the best people and treat them well. Nowhere is Walgreens responding to employee needs better than in the development of computer systems. Intercom, in particular, has been a boon to pharmacists, and is proving a plus in the recruitment of recent pharmacy graduates. Walgreen store managers will gain similar job enhancement from the WIN system.

"Investments in technology," says Vice President of Human Resources John Rubino, "show employees you're determined to provide the best tools available... that in caring about the future of the business, you're also caring about *their* futures.

"And people see opportunity here. We're adding stores faster than ever before... a hard-working, ambitious person can advance quickly, get excellent retail experience and training, build a solid career."

Anticipate consumer trends.

- The 65-year-and-over population group will increase 36 percent between 1980 and the year 2000. Persons in that group rely on an average of seven prescriptions per year, compared to 2.3 for people aged 25 to 44.
- Projections call for nearly four million births in the U.S. in 1988, an 11 percent increase over 1984.
- Sixty-two percent of women aged 16 to 64 now work outside the home.
- By the year 2000 there will be more than 30 million Hispanic residents in the United States. Today's 18 million Hispanics represent an annual U.S. retail sales market of more than $70 billion.
- Single-person households are increasing faster than ever before.
- More than 59 million Americans are between 25 and 39 years old, and nearly one-fourth of them are college graduates.

Demographic trends favor Walgreens, but population figures are only as good as the retail sales they generate, emphasizes Vern Brunner. "We have to look at the numbers, then jump ahead... project how we'll market and merchandise our stores in five, ten, even twenty years."

The opportunities—and challenges—for drugstores are enormous. 1985's births translate into millions of one-year birthday cards in '86 and back-to-school supplies in 1990... single-person households mean increased sales of high-margin single-serving packages of food... heavy Hispanic markets need Spanish-language advertising... two-salary families have more disposable income, which they spend with the most convenient retailers... well-educated consumers tend to spend more money on health and exercise-related products...

"I think we anticipate consumer needs better than most drug chains," says Brunner. "Our marketing success is largely due to information systems. No one analyzes sales better than our research department. We know product movement by day, by promotion, by item and category—it's invaluable.

"But we can and must do better. An important challenge is to draw more young families into our stores... as pharmacy customers, photofinishing customers, cosmetic customers. As we get children on the Intercom system, we develop family shopping patterns that last for years. As we market the completeness of our photofinishing capabilities, we gain a larger share of a growing category... the average family with two kids snaps 121 pictures a year—that's double the camera use of ten years ago!"

Concentrate on basics.

"In everything we do," concludes Charles R. Walgreen III, "we concentrate on the basics." Studies forecast that the retailers who will flourish during the next five years will provide first-rate customer service, quality merchandise, good in-stock positions, reduced transaction time, and a pleasant shopping environment. "It's called optimum convenience," says the chairman, "and you get it by paying attention to *every* detail.

"That's the way we manage Walgreens today... it's the way we'll *continue* to build our company for the future."

Photo—"What I love about pharmacy is the 'marketing' aspect—the people contact," explains Audrey Neely (left), chief pharmacist at Walgreens Chicago Heights store. "My job is to create a customer base, and that means a whole lot more than just selling prescriptions. As a pharmacist, you really have to 'sell' yourself—and the concern you and your company have for the customer's health. If you view yourself simply as a person who puts pills in bottles and hands them across the counter, then I guess that's what you are. A profession is what you make it, and I've always seen pharmacy—and my job—as a crucial link in the total community health care scheme."

Audrey's customers are predominately 65 and older; many, like Betty Pluskiss (center), are active in the nearby Chicago Heights Senior Citizens Center where Audrey frequently counsels members on prescription drug use, vitamins and generic cost savings.

Walgreen Drugstores Nationwide

Alabama	3	Missouri	35
Arizona	53	Nebraska	23
Arkansas	6	New Jersey	1
California	46	New Mexico	19
Colorado	37	New York	6
Connecticut	1	North Dakota	1
Florida	159	Ohio	15
Illinois	226	Oklahoma	2
Indiana	27	South Dakota	1
Iowa	25	Tennessee	45
Kansas	5	Texas	169
Kentucky	27	Wisconsin	84
Louisiana	25	Puerto Rico	19
Michigan	6		
Minnesota	25		
Mississippi	4	Total	1095

Financial Information

Eleven-Year Summary of Selected Financial Data (1)

Walgreen Co. and Subsidiaries
(Dollars in Thousands, except per share data)

	Fiscal Year	1985	1984	1983
Net Sales	Drugstores	$3,028,034	$2,614,265	$2,238,217
	Food Services	122,322	119,411	112,815
	Other Sales	11,579	10,949	9,582
Costs and Deductions	Cost of sales	2,192,367	1,900,703	1,637,133
	Selling, occupancy and administration	791,697	691,139	601,623
	Other expense (income)	4,171	2,800	1,309
		2,988,235	2,594,642	2,240,065
Earnings	Earnings from U.S. operations before income taxes	173,700	149,983	120,549
	Income taxes	79,531	69,340	53,873
	Earnings from U.S. operations	94,169	80,643	66,676
	Equity in net earnings of Mexican operations	—	1,205	3,113
	Gain on sale of equity investments in Mexican operations, net of income taxes	—	3,598	—
	Net Earnings	$ 94,169	$ 85,446	$ 69,789
Net Earnings per Share(2)	Assuming full dilution	$ 1.53	$ 1.39	$ 1.13
	Assuming no dilution	1.53	1.39	1.14
Per Share(2)	Dividends Declared	$ .44	$ .36	$ .30
	Shareholders' Equity	7.83	6.76	5.74
Long-Term Obligations	Debt	$ 44,336	$ 24,472	$ 24,821
	Capital Leases	27,604	28,725	29,142
Assets and Equity	Total Assets	$ 961,938	$ 840,803	$ 718,022
	Shareholders' Equity	$ 480,974	$ 414,618	$ 351,705
	Return on Average Shareholders' Equity	21.0%	22.3%	21.4%

(1) Excludes the operations of the Globe Discount Department Store Division discontinued in fiscal 1978.
(2) Per share data have been adjusted for two-for-one stock splits in 1985, 1983 and 1982.

1982	1981	1980	1979	1978	1977	1976	1975
$1,924,335	$1,634,747	$1,411,356	$1,222,674	$1,076,428	$ 952,679	$ 903,766	$ 835,349
104,279	97,769	91,350	90,497	87,174	84,795	81,094	75,959
10,882	10,955	28,016	31,371	29,253	28,543	25,536	22,924
2,039,496	1,743,471	1,530,722	1,344,542	1,192,855	1,066,017	1,010,396	934,232
1,416,941	1,231,009	1,079,836	943,880	833,678	744,648	722,063	676,035
534,531	453,131	396,400	348,830	313,115	279,313	260,175	239,965
2,322	(2,467)	590	911	1,544	5,800	4,985	4,071
1,953,794	1,681,673	1,476,826	1,293,621	1,148,337	1,029,761	987,223	920,071
85,702	61,798	53,896	50,921	44,518	36,256	23,173	14,161
37,209	25,677	23,008	22,960	20,282	17,069	10,493	5,556
48,493	36,121	30,888	27,961	24,236	19,187	12,680	8,605
7,571	6,006	3,925	2,332	1,560	510	1,864	1,543
—	—	—	—	—	—	—	—
$ 56,064	$ 42,127	$ 34,813	$ 30,293	$ 25,796	$ 19,697	$ 14,544	$ 10,148
$ .91	$ .69	$ .59	$ .52	$ .44	$ .34	$ .25	$ .18
.93	.73	.64	.57	.48	.37	.27	.19
$ .25	$ .22	$ .1938	$ .1719	$ .1469	$ .1375	$ .125	$ .125
4.90	4.24	3.72	3.28	2.88	2.57	2.42	2.28
$ 27,738	$ 37,349	$ 53,232	$ 57,515	$ 58,065	$ 66,411	$ 65,882	$ 66,644
26,830	27,536	28,320	26,480	17,469	14,249	12,696	12,358
$ 616,434	$ 521,041	$ 448,633	$ 402,350	$ 359,702	$ 328,282	$ 306,752	$ 288,802
$ 299,189	$ 250,503	$ 207,379	$ 175,248	$ 153,482	$ 136,913	$ 128,869	$ 121,024
20.4%	18.4%	18.2%	18.4%	17.8%	14.8%	11.6%	8.5%

Results of Operations

Earnings from U.S. operations increased 16.8% to over $94 million versus a 20.9% increase in 1984, reflecting the continuing strength of the drugstore business. Fiscal 1985 results were achieved despite the earnings impact of an accelerated store opening pace, which resulted in a record 106 drugstores being added during the year. As a percentage of sales, U.S. earnings continue to increase, resulting in a 3.0% net to sales ratio.

Net earnings per share advanced $.14, to $1.53 per share in 1985, following a rise of $.25 per share in 1984. Fiscal 1984 had the benefit of a non-recurring gain from the sale of the Company's Mexican operations ($.06 per share) and equity income from those operations ($.02 per share).

Sales increased to $3.16 billion in fiscal 1985, up 15.2%, compared to gains of 16.3% in 1984, and 15.7% in 1983. Drug Store Division sales, with strong contributions from both existing and new stores, were up 15.8% in 1985, compared to growth of 16.8% in 1984 and 16.3% in 1983. Sales of comparable stores (stores opened at least one full year) increased 8.5% in 1985. Prescription sales continue to excel with increases of 26%, 23% and 25% in 1985, 1984 and 1983, respectively. Sales include an indeterminate amount of inflation-related price increases.

Cost of sales, influenced by many variables such as sales mix and inflation, remained at the same level, as a percentage of sales, in 1985 as 1984, 69.3%. The favorable shift in sales mix toward the higher profit prescription category was offset by the effects of aggressive pricing in the prescription and drug departments to meet increased competition and to develop a customer base for new stores.

The Company uses the last-in, first-out (LIFO) method of inventory valuation. During periods of changing prices, cost of sales on a LIFO basis and sales are stated in dollars of approximately the same purchasing power, which provides a better matching of revenue and expense. In 1985, the effective LIFO inflation rate decreased to 1.9% from 2.8%, reflecting a reduction of inflation in non-prescription merchandise. The following table is presented as a further explanation of and supplemental to the statement of earnings to provide additional facts on LIFO and to enable comparisons with companies using the first-in, first-out (FIFO) method of inventory valuation (dollars in thousands).

Fiscal Year	1985	1984	1983
LIFO Provision	$10,228	$12,470	$10,929
Effective Inflation Rate	1.9%	2.8%	2.7%
U.S. Earnings – Before LIFO Provision	$99,394	$87,006	$72,247
U.S. Earnings – After LIFO Provision	$94,169	$80,643	$66,676

Additional inflation-adjusted financial data appears on pages 35-37.

Selling, occupancy and administration expenses were reduced in 1985 to 25% of sales, from 25.2% in 1984 and 25.5% in 1983. This was achieved despite cost increases in existing locations and start-up costs for the record number of new locations. Drugstores added in the last three years total 245 which represents over 22% of the units in operation at August 31, 1985.

The effective income tax rate on U.S. earnings declined in 1985 to 45.8% from 46.2% in 1984, compared with 44.7% in 1983. The variations primarily represent the combined effect of increased income taxable at statutory rates and changes in the level of investment tax credit.

Financial Condition

The Company continues to maintain a strong financial position and neither has nor anticipates any liquidity problems. In 1985, Company operations generated over $97 million of cash flow, after providing the additional inventories necessary to support company growth. These funds, supplemented by the receipt of $29 million of proceeds from the 1984 sale of the Company's Mexican operations, and $25 million from a mortgage borrowing, supported over $97 million of capital expenditures in 1985.

Cash and marketable securities increased over $25 million to $82 million at August 31, 1985, providing financial flexibility. In the past three years, Company operations have provided cash totaling $282 million, and capital expenditures, net of disposals, were $216 million.

Internally generated funds will continue to be relied upon as the primary source for working capital and capital expansion needs. Approximately $120 million of capital expenditures are projected for fiscal 1986 which includes plans for more than 120 new stores, including 26 recently acquired stores in northern Indiana, 70 major remodels and expansion of three distribution centers. At August 31, 1985, the Company had approximately $60 million in unused bank lines of credit.

Consolidated Statements of Earnings and Retained Earnings

Walgreen Co. and Subsidiaries
For the Years Ended August 31, 1985, 1984 and 1983
(Dollars in Thousands, except per share data)

	Earnings	1985	1984	1983
Net Sales		$3,161,935	$2,744,625	$2,360,614
Costs and Deductions	Cost of sales	2,192,367	1,900,703	1,637,133
	Selling, occupancy and administration	791,697	691,139	601,623
		2,984,064	2,591,842	2,238,756
Other Expense (Income)	Interest expense	5,922	5,830	6,132
	Interest income	(1,751)	(3,030)	(3,544)
	Gains from sale of assets	—	—	(1,279)
		4,171	2,800	1,309
Earnings	Earnings from U.S. operations before income taxes	173,700	149,983	120,549
	Income taxes	79,531	69,340	53,873
	Earnings from U.S. operations	94,169	80,643	66,676
	Equity in net earnings of Mexican operations	—	1,205	3,113
	Gain on sale of equity investments in Mexican operations, net of income taxes	—	3,598	—
	Net earnings	$ 94,169	$ 85,446	$ 69,789
Net Earnings per Common Share		$ 1.53	$ 1.39	$ 1.14

Retained Earnings	1985	1984	1983
Balance, beginning of year	$ 335,812	$ 272,449	$ 240,164
Net earnings	94,169	85,446	69,789
Dividends declared:			
Cash—$.44 per share in 1985, $.36 in 1984 and $.30 in 1983	(27,009)	(22,083)	(18,375)
Stock—100% in 1983	—	—	(19,129)
Balance, end of year	$ 402,972	$ 335,812	$ 272,449

The accompanying statement of major accounting policies and the notes to consolidated financial statements are an integral part of these statements.

Consolidated Balance Sheet

Walgreen Co. and Subsidiaries
At August 31, 1985 and 1984
(Dollars in Thousands)

	Assets	1985	1984
Current Assets	Cash	$ 24,987	$ 20,053
	Marketable securities, at cost which approximates market	57,446	36,540
	Receivable from sale of Mexican operations	—	29,000
	Accounts receivable, less allowances of $4,013 in 1985 and $3,052 in 1984 for doubtful accounts	29,246	21,485
	Inventories	459,258	406,190
	Other current assets	22,568	18,570
	Total Current Assets	593,505	531,838
Non-Current Assets	Property and Equipment, at cost, less accumulated depreciation and amortization	343,094	281,827
	Leased Properties under Capital Leases, less accumulated amortization	23,902	25,569
	Other non-current assets	1,437	1,569
		$961,938	$840,803

	Liabilities & Shareholders' Equity	1985	1984
Current Liabilities	Trade accounts payable	$181,770	$156,042
	Accrued expenses and other liabilities	139,190	129,043
	Income taxes	10,686	31,620
	Current maturities of long-term debt and obligations under capital leases	4,831	3,374
	Total Current Liabilities	336,477	320,079
Long-Term Obligations	Long-Term Debt, less current maturities—		
	General company obligations	6,227	7,915
	Real estate obligations	38,109	16,557
		44,336	24,472
	Deferred Income Taxes	72,547	52,909
	Obligations under Capital Leases, less current maturities	27,604	28,725
Shareholders' Equity	Common stock, $1.25 par value; authorized 100,000,000 shares; issued and outstanding 61,397,868 in 1985 and 61,351,244 in 1984, at stated value	78,002	78,806
	Retained earnings	402,972	335,812
		480,974	414,618
		$961,938	$840,803

The accompanying statement of major accounting policies and the notes to consolidated financial statements are an integral part of this statement.

Consolidated Statement of Changes in Financial Position

Walgreen Co. and Subsidiaries
For the Years Ended August 31, 1985, 1984 and 1983
(Dollars in Thousands)

	Fiscal Year	1985	1984	1983
Cash Provided by Operations	Net earnings	$ 94,169	$ 85,446	$ 69,789
	Non-cash expenses (income)—			
	Depreciation and amortization	34,350	28,605	25,101
	LIFO inventory provision	10,228	12,470	10,929
	Deferred income taxes	19,638	15,086	9,693
	Equity income from investments, net of dividends received	—	155	(1,913)
	Total from net earnings	158,385	141,762	113,599
	Cash provided by (used for) current assets and liabilities—			
	Inventories at FIFO	(63,296)	(91,844)	(47,349)
	Trade accounts payable	25,728	11,761	19,655
	Accrued expenses and other liabilities	8,915	15,068	13,311
	Income taxes	(20,934)	17,718	6,152
	Other operating working capital items	(11,706)	(8,548)	(6,286)
		(61,293)	(55,845)	(14,517)
	Total cash provided by operations	97,092	85,917	99,082
Cash Dividends Paid		(25,777)	(21,160)	(17,579)
Cash Provided by (Used for) Investments and Financing	Additions to property and equipment and leased properties under capital leases	(97,302)	(68,237)	(71,355)
	Net book value of property and equipment and leased properties under capital leases retired or sold	3,352	2,298	15,559
	Collection of receivable from sale of Mexican operations	29,000	(29,000)	—
	Net book value of Mexican operations sold	—	19,890	—
	Retirement of 5½% convertible subordinated debentures	(188)	(112)	(1,230)
	Common stock transactions—			
	Conversion of 5½% convertible subordinated debentures (46,624 shares in 1985, 27,776 shares in 1984 and 305,040 shares in 1983)	191	113	1,242
	Stock issued for employee stock purchase and option plans (—0— shares in 1985, —0— shares in 1984, and 552 shares in 1983)	—	—	7
	Cost of employee stock purchase and option plans	(995)	(563)	(147)
	Payments of long-term debt and capital lease obligations	(3,374)	(3,296)	(3,220)
	New long-term debt and obligations under capital leases, net of retirements	23,709	2,630	3,943
	Other	132	283	90
	Net cash used for investments and financing	(45,475)	(75,994)	(55,111)
Changes in Cash and Marketable Securities	Net increase (decrease) in cash and marketable securities	25,840	(11,237)	26,392
	Cash and marketable securities at beginning of year	56,593	67,830	41,438
	Cash and marketable securities at end of year	$ 82,433	$ 56,593	$ 67,830

The accompanying statement of major accounting policies and the notes to consolidated financial statements are an integral part of this statement.

Statement of Major Accounting Policies

Audit Committee

Three outside members of the Board of Directors comprise the Company's Audit Committee. Regular meetings of the committee are held with Company management and the independent public accountants to monitor and review financial and accounting matters.

Principles of Consolidation

The consolidated statements include the accounts of the Company and all majority-owned subsidiaries. All significant intercompany transactions have been eliminated.

In August, 1984, the Company sold its equity investments in Mexican operations, which was primarily a 46.9% ownership of Sanborn Hermanos, S.A., for $30,000,000. The sale resulted in a gain of $3,598,000 ($.06 per share), net of income taxes of $6,355,000. A $29,000,000 receivable from the sale was collected in September, 1984.

Inventories

Inventories are valued on a last-in, first-out (LIFO) cost basis. At August 31, 1985 and 1984, inventories would have been greater by $149,134,000 and $138,906,000 respectively, if they had been valued on a lower of first-in, first-out (FIFO) cost or market basis. Cost of sales is primarily computed on an estimated basis and adjusted periodically based on physical inventories. At August 31, 1983, the Company experienced lower inventory levels in certain LIFO pools compared with the previous year-end inventory levels, which caused a liquidation of LIFO inventories which were carried at lower costs prevailing in prior years. The effect of this liquidation was to reduce cost of sales by $1,098,000 and increase net earnings by $560,000 ($.01 per share) in 1983.

Property and Capital Leases

Depreciation is provided on a straight-line basis over the estimated useful lives of owned assets. Leasehold improvements and leased properties under capital leases are amortized over the estimated physical life of the property or over the term of the lease, whichever is shorter. Major repairs which extend the useful life of an asset are charged to the property and equipment accounts. Routine maintenance and repairs are charged against earnings. The composite method of depreciation is used for equipment; therefore, gains and losses on retirements or other disposition of such assets are included in earnings only when an operating location is closed or completely remodeled. Fully depreciated property and equipment are excluded from the cost and related accumulated depreciation and amortization accounts.

Property and equipment consists of (In Thousands):	1985	1984
Land and land improvements	$ 14,064	$ 11,761
Buildings and building improvements	148,502	116,926
Equipment	306,933	256,385
	469,499	385,072
Less—accumulated depreciation and amortization	126,405	103,245
	$343,094	$281,827

Leased properties under capital leases consists of (In Thousands):	1985	1984
Retail store, warehouse, and office facilities	$ 38,329	$ 38,442
Less—accumulated amortization	14,427	12,873
	$ 23,902	$ 25,569

Deferred Income Taxes

The Company provides federal and state income taxes on items included in the Consolidated Statement of Earnings regardless of the period when such taxes are payable. Deferred income taxes result from timing differences in the recognition of income and expense for tax and financial statement purposes. These timing differences principally result from additional tax deductions available due to the use of accelerated methods of depreciation.

Investment Tax Credit

The Company reflects the investment tax credit as a reduction in federal income taxes in the year eligible property and equipment purchases are put into service.

Pre-Opening Expenses

Non-capital expenditures incurred prior to the opening of a new or remodeled store are charged against earnings when they are incurred.

Long-Term Debt

Long-term debt, less current maturities, consists of (In Thousands):

Issue	Interest Rate	Principal 1985	Principal 1984
General Company Obligations—			
Senior Notes payable to insurance companies, due 1986 through 1990	11%	$ 6,000	$ 7,500
Convertible Subordinated Debentures, due 1991	5½%	227	415
		6,227	7,915
Real Estate Obligations—			
Mortgage Obligations	5%—10¾%	33,484	11,722
Industrial Revenue Bonds	6¼%—7.7%	4,625	4,835
		38,109	16,557
		$44,336	$24,472

The Senior Notes payable to insurance companies, issued August 15, 1975, require annual principal payments of $1,500,000 from 1986 through 1990. The 5½% Convertible Subordinated Debentures are convertible into common shares at the rate of 248 shares per $1,000 principal amount. At August 31, 1985, 56,296 common shares were reserved for such conversions. The debentures are subordinated to all other borrowings of the Company. At the Company's option, the debentures are redeemable at prices ranging from 101.447% in 1985 to par in 1990.

In August, 1985, the Company received $25,000,000 in proceeds from 10.75% Senior Notes, secured by mortgages on 33 properties, requiring semi-annual payments of interest and principal until 1995.

Other mortgages provide for monthly payments of principal and interest and become fully retired between 1986 and 2000. The Industrial Revenue Bonds are due in annual installments payable from 1986 through 1999. The Mortgage Obligations and Industrial Revenue Bonds are secured by properties having a net book value of $38,715,000 at August 31, 1985.

Under the most restrictive covenants of the Company's debt agreements: (a) $279,702,000 of the consolidated retained earnings at August 31, 1985 is available for payment of cash dividends, or for repurchase of the Company's stock, and (b) consolidated net working capital, as defined, must be at least $85,000,000. Consolidated net working capital, as defined, was $330,455,000 at August 31, 1985.

Annual maturities due on long-term debt in fiscal 1986 through 1990 are as follows (In Thousands):

1986	1987	1988	1989	1990
$3,631	$3,643	$3,866	$4,112	$4,378

Short-Term Borrowings

At August 31, 1985, the Company had approximately $60,000,000 of bank lines of credit. The credit lines are renewable annually at various dates and provide for loans of varying maturities at the prime rate. There are no compensating balance arrangements.

There were no outstanding short-term borrowings at August 31, 1985, 1984 and 1983. During 1985, 1984 and 1983, the Company did obtain funds through the placement of commercial paper, as follows (In Thousands):

	1985	1984	1983
Average outstanding during the year	$ 4,400	$ 5,100	$ 4,700
Largest month-end balance	16,300 (Nov)	21,400 (Nov)	25,600 (Nov)
Weighted average interest rate during the year	9.1%	9.3%	9.0%

Interest Expense

Interest expense includes interest related to capitalized leases of $3,059,000, $3,039,000 and $2,792,000 for the fiscal years ended August 31, 1985, 1984 and 1983. The Company capitalized $360,000, $359,000 and $344,000 of interest expense as part of significant construction projects during fiscal 1985, 1984 and 1983, respectively.

Gains from Sale of Assets

Gains from sale of assets for the fiscal year ended August 31, 1983, resulted from the disposition of a security investment carried on the cost method.

Leases

The Company generally operates in leased premises. Original non-cancelable lease terms typically range from ten to twenty years and normally have options that permit renewals for additional periods. In addition to minimum fixed rentals, most leases provide for contingent rentals based upon sales. Certain of the Company's leases have been identified as capital leases.

Minimum rental commitments at August 31, 1985, under capital leases, all of which are for leased premises, and operating leases having an initial or remaining non-cancelable term of more than one year are shown below (In Thousands):

Year	Capital Leases	Operating Leases	Total
1986	$ 5,308	$ 74,707	$ 80,015
1987	5,262	76,792	82,054
1988	5,270	74,761	80,031
1989	5,274	72,838	78,112
1990	5,168	70,313	75,481
After 1990	43,918	689,247	733,165
Total minimum lease payments	70,200	$1,058,658	$1,128,858
Less: Estimated executory costs	10,176		
Less: Amount representing interest	31,220		
Present value of net minimum capital lease payments	$28,804		

In arriving at the present value of net minimum capital lease payments, which are reflected on the accompanying balance sheet as current and non-current obligations under capital leases, estimated executory costs (such as taxes, maintenance and insurance) and interest costs (calculated at the Company's incremental borrowing rate at the inception of the individual leases) which are included in total minimum capital lease payments have been excluded. Total minimum lease payments have not been reduced by minimum sublease rentals of approximately $8,500,000 on operating leases due in the future under non-cancelable subleases.

Rental expense was as follows (In Thousands):

	1985	1984	1983
Operating leases—Minimum rentals	$82,006	$71,918	$59,980
—Contingent rentals	19,483	15,884	14,130
Capital leases—Contingent rentals	670	522	378
Less: Sublease rental income	(4,088)	(2,952)	(2,720)
	$98,071	$85,372	$71,768

Income Taxes

The provision for income taxes for the fiscal years ended August 31, 1985, 1984 and 1983, consists of the following (In Thousands):

	1985	1984	1983
Currently payable—			
Federal	$52,772	$45,847	$27,693
State	7,121	6,669	5,647
	59,893	52,516	33,340
Purchased tax benefits	—	1,738	10,840
Deferred to future periods—			
Federal	17,641	13,329	8,770
State	1,997	1,757	923
	19,638	15,086	9,693
	$79,531	$69,340	$53,873

In fiscal 1983 and 1982 the Company entered into tax benefit leases which resulted in reductions of income tax liability for fiscal 1984 and 1983 without corresponding reductions of income tax expense.

The difference between the U.S. statutory income tax rate and the effective tax rate is principally due to investment tax credits amounting to $5,000,000 in 1985, $3,550,000 in 1984 and $4,500,000 in 1983, and state income tax provisions.

Income from foreign operations was not material in 1985, but contributed 7.2% of consolidated pre-tax earnings in 1984 and 3.5% in 1983. In 1984, the principal portion of the foreign income was the gain on the sale of the Company's investment in Mexican operations.

Net Earnings per Common Share

Primary net earnings per share were computed using weighted average number of shares and common share equivalents outstanding of 61,475,214 in 1985, 61,419,280 in 1984 and 61,276,776 in 1983.

The dilutive effect of the outstanding 5½% Convertible Subordinated Debentures is not material. If the debentures were fully converted, the interest expense eliminated, net of profit-sharing and income taxes, would be $8,000, $13,000, and $26,000 for the years ended August 31, 1985, 1984 and 1983. The weighted average number of common shares assumed to be converted during 1985, 1984 and 1983 were 79,021; 115,176; and 244,428, respectively.

Litigation

The Company is involved in various legal proceedings incidental to the normal course of business. Company management is of the opinion, based upon the advice of General Counsel, that although the outcome of such litigation cannot be forecast with certainty, the final disposition should not have a material adverse effect on the Consolidated Statement of Earnings or financial position of the Company.

Capital Stock

In 1985 and in 1983, two-for-one stock splits were effected in the form of 100% stock dividends. The par value of the additional shares issued in 1983 was transferred from retained earnings to common stock in accordance with state legal requirements. The stock splits had no effect on total shareholders' equity and all share data have been adjusted to reflect the splits. In 1984, the number of authorized shares was increased from 40,000,000 to 100,000,000.

As of August 31, 1985, 7,779,000 shares of common stock were reserved for issuance under employee stock purchase, option and award plans. There are authorized 1,000,000 shares of a $1 per share par value preferred stock issuable in series. The rights of this preferred stock as to dividends, redemptions and liquidation will be determined when, as and if issued.

Stock Option Plan

In fiscal 1983, the Company adopted the Walgreen Co. 1982 Executive Incentive Stock Option Plan; shareholders approved the plan at the annual meeting on January 12, 1983.

The Stock Option Plan provides for the granting to key employees of options to purchase Company common stock over a 10 year period, at a price not less than the fair market value on the date of grant. Options may be issued under the plan, until October 13, 1992, for an aggregate of 2,400,000 shares of common stock of the Company.

A summary of option transactions is as follows:

	Shares	Per Share Option Price
Outstanding August 31, 1982	—0—	—
Granted	211,716	$10.813—$14.813
Exercised	(16,648)	10.813— 13.56
Cancelled	(1,440)	10.813
Outstanding August 31, 1983	193,628	10.813— 14.813
Granted	3,450	15.75 — 17.50
Exercised	(44,842)	10.813— 13.56
Cancelled	—0—	—
Outstanding August 31, 1984	152,236	10.813— 17.50
Granted	114,567	19.50 — 26.875
Exercised	(54,482)	10.813— 19.50
Cancelled	(918)	19.50
Outstanding August 31, 1985	211,403	$10.813—$26.875

Retirement Benefits

The Company has a retirement plan for employees known as the Walgreen Profit-Sharing Retirement Trust, to which both the Company and the employees contribute. The Company's contribution, computed by a formula specified by the Trust Agreement, is related to pre-tax income, and is reduced by the Company's payment for profit-sharing member's Social Security and Medicare tax that is in excess of 5.2% of annual wages subject to such taxes. The profit-sharing provision was $17,812,000 in 1985, $17,180,000 in 1984, and $13,577,000 in 1983.

The Company has a Retirement Income Security Plan for profit-sharing members and an unfunded Supplemental Retirement Plan for certain executives. These plans, which are non-contributory, provide supplemental benefits to eligible profit-sharing members if retirement benefits under the profit-sharing plan fall below defined minimum levels. The actuarially computed pension expense under these plans for fiscal 1985, 1984 and 1983 was $267,000, $458,000 and $583,000 respectively, which includes amortization of past service costs over 10 years. The 1985 expense decreased mainly due to changes made in the benefit formula of the Retirement Income Security Plan. In 1984, the expense decreased due to changes in actuarial assumptions for future Company contributions to the profit-sharing plan.

At January 1, 1985, the actuarial present value of accumulated plan benefits for the Retirement Income Plan was $1,119,000 ($787,000 vested and $332,000 non-vested) compared to $1,133,000 ($813,000 vested and $320,000 non-vested) at January 1, 1984. The net assets available for benefits were $1,537,000 at January 1, 1985 and $1,262,000 at January 1, 1984. An assumed rate of return of 7% was used in determining accumulated plan benefits. The Company's policy is to fund the pension costs for the Retirement Income Security Plan as accrued.

The Company provides certain health and life insurance benefits for retired employees who meet eligibility requirements, including age and years of service. The cost of retiree benefits is primarily expensed as benefits are paid and amounted to $1,096,000 for 1985.

Supplementary Financial Information

The Consolidated Statement of Earnings includes advertising costs of $50,400,000 in 1985, $44,116,000 in 1984 and $37,903,000 in 1983.

Included in the Consolidated Balance Sheet caption "Accrued expenses and other liabilities" are the following liabilities (In Thousands):

	1985	1984
Accrued salaries	$ 40,130	$ 37,210
Accrued taxes	22,200	18,917
Accrued rent	19,690	15,435
Insurance	16,512	16,064
Other current liabilities	40,658	41,417
	$139,190	$129,043

Business Segments

The Company's dominant business activity is the operation of retail drugstores. Various supporting or vertical operations of the Company, including manufacturing and photofinishing studio operations, are an integral part of the drugstore operations.

Auditors' Report

To the Board of Directors and Shareholders of Walgreen Co.:

We have examined the consolidated balance sheet of Walgreen Co. (an Illinois corporation) and Subsidiaries as of August 31, 1985, and 1984, and the related consolidated statements of earnings, retained earnings and changes in financial position for each of the three years in the period ended August 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Walgreen Co. and Subsidiaries as of August 31, 1985, and 1984, and the results of their operations and the changes in their financial position for each of the three years in the period ended August 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis.

Arthur Andersen & Co.

Chicago, Illinois,
October 8, 1985.

Management's Report

The primary responsibility for the integrity and objectivity of the consolidated financial statements and related financial data rests with the management of Walgreen Co. The financial statements were prepared in conformity with generally accepted accounting principles appropriate in the circumstances and included amounts that were based on management's most prudent judgements and estimates relating to matters not concluded by fiscal year-end. Management believes that all material uncertainties have been either appropriately accounted for or disclosed. All other financial information included in this annual report is consistent with the financial statements.

The Company's systems are designed to provide an effective system of internal accounting controls to obtain reasonable assurance at reasonable cost that assets are safeguarded from material loss or unauthorized use and transactions are executed in accordance with management's authorization and properly recorded. To this end, management maintains an internal control environment which is shaped by established operating policies and procedures, an appropriate division of responsibility at all organizational levels, and a corporate ethics policy which is monitored annually. The Company also has an Internal Control Evaluation Committee, comprised mostly of senior management from the Accounting and Auditing Departments, which oversees the evaluation of internal controls on a Company-wide basis.

The firm of Arthur Andersen & Co., independent public accountants, was engaged to render a professional opinion on Walgreen Co.'s consolidated financial statements. Their report contains an opinion based on their examination which was made in accordance with generally accepted auditing standards and procedures which they believed were sufficient to provide reasonable assurance that the consolidated financial statements, considered in their entirety, are not misleading and do not contain material errors.

Three outside members of the Board of Directors comprise the Company's Audit Committee, which meets at least quarterly and is responsible for reviewing and monitoring the Company's financial and accounting practices. In order to insure and maintain complete independence, Arthur Andersen & Co. and the Company's General Auditor have access to meet alone with the Audit Committee, which also meets with Company management to discuss financial matters, auditing and internal accounting controls.

C. D. Hunter

C. D. Hunter
Executive Vice President
and Chief Financial Officer

Inflation-Adjusted Financial Data (Unaudited)

The accompanying financial data reflects adjustments for changing prices or inflation under the current cost method specified by Financial Accounting Standards (FAS) No. 33, as amended by FAS No. 82. The rules require inflation adjustments for inventories, properties, cost of sales, and depreciation and amortization. In particular, income tax expense is not to be changed.

The current cost method shows the effects of changing prices on specific resources used by the Company. Year-end inventories are valued at current replacement values while cost of sales is stated so as to match current costs of inventory against sales. Property and equipment values were determined by indexation, direct pricing, and functional pricing which provides for productivity on a replacement basis.

Certain management policies reduce adverse effects of inflation. For instance, we take full advantage of any inflation benefits available under income tax laws relating to inventories and properties. The LIFO method of inventory valuation improves our cash flow by reducing income taxes which reduces the need for borrowing, thereby strengthening the balance sheet. LIFO matches current costs against current revenues. Therefore, cost of sales is already inflation-adjusted in the historical financial statements for specific price changes and remains unchanged under the current cost method.

Property and Equipment is another important group of assets affected by inflation. For tax purposes the Company uses the maximum depreciation allowance under the Accelerated Cost Recovery System. This improves cash flow and provides dollars to replace assets at higher costs. The Company has an aggressive remodeling and replacement program. This means assets in use are reasonably new, of modern design, and productive. If the assets in use were years older, the impact of inflation would be far greater.

In conclusion, management policies can reduce the effects of inflation. The reader should be cautious in using the information presented, as preparers and users of financial statements have not yet reached a consensus on its usefulness.

Statement of Earnings Adjusted for Changing Prices

For the Year Ended August 31, 1985
(Dollars in Thousands, except per share data)

		As Reported in the Primary Statements (Historical Cost)	Adjusted for Changes in Specific Prices (Current Cost)
Net Sales		$3,161,935	$3,161,935
Costs and Deductions	Cost of sales	2,188,415	2,188,415
	Depreciation and amortization expense	34,350	40,788
	Selling, occupancy and administration	761,299	761,299
	Other expense	4,171	4,171
		2,988,235	2,994,673
Earnings	Earnings before income taxes	173,700	167,262
	Income taxes	79,531	79,531
	Net earnings	$ 94,169	$ 87,731
Net Earnings per Share		$ 1.53	$ 1.43
	Effective U.S. income tax rate	45.8%	47.5%
	Purchasing power gain from holding net monetary liabilities during the year		$ 10,777
	Increase in general price level of inventories, and property, plant and equipment held during the year		$ 32,887
	Less—effect of increase in specific prices (current cost)*		23,708
	Excess of increase in general price level over increase in specific prices		$ 9,179

**At August 31, 1985, current cost of inventory was $608,000 and current cost of property and equipment (including capital leases), net of accumulated depreciation and amortization, was $452,000.*

Five-Year Comparison of Inflation-Adjusted Data

All Inflation-Adjusted Amounts Stated in Average 1985 Dollars
(Dollars in Thousands, except per share data)

	Fiscal Year	1985	1984	1983	1982	1981
Net Sales	As Reported	$3,161,935	$2,744,625	$2,360,614	$2,039,496	$1,743,471
	Specific Price Index—(A)	3,161,935	2,831,630	2,516,415	2,263,229	2,083,099
	In Constant Dollars	3,161,935	2,848,372	2,546,866	2,281,584	2,104,893
Net Earnings	As Reported	$ 94,169	$ 85,446	$ 69,789	$ 56,064	$ 42,127
	In Current Cost	87,731	82,247	68,377	56,033	44,115
Earnings per Share	As Reported	$ 1.53	$ 1.39	$ 1.14	$ .93	$ .73
	In Current Cost	1.43	1.34	1.11	.93	.76
Purchasing Power gain from holding net monetary liabilities		$ 10,777	$ 12,509	$ 5,957	$ 14,442	$ 22,199
General price level increases in excess of (less than) the increase in specific prices		$ 9,179	$ 21,217	$ (1,981)	$ 13,408	$ 852
Common Stock Dividends per Share	As Reported	$ .44	$ .36	$ .30	$ .25	$ .22
	In Constant Dollars	.44	.37	.32	.28	.27
Net Assets at Year End	As Reported	$ 480,974	$ 414,618	$ 351,705	$ 299,189	$ 250,503
	In Current Cost	724,487	643,535	594,878	540,509	491,853
Market Price per Common Share at Year End	In Historical Dollars	$ 25.625	$ 19.50	$ 16.75	$ 9.00	$ 5.55
	In Constant Dollars	25.24	19.85	17.77	9.79	6.39
Average Consumer Price Index		318.6	307.0	295.3	284.8	263.9

(A) *An internal index developed from merchandise cost increases reflected in year-end inventories.*

The Walgreen Year... A Review by Quarters (Unaudited)

Summary of Quarterly Results, Fiscal 1985 and 1984
(Dollars in Thousands, except per share data)

		1985	1984
Quarter Ended: November	Sales	$ 715,155	$ 613,016
	Gross profit	215,278	185,340
	Net earnings	15,561	12,504
	Earnings per share	$ .25	$ .20
Quarter Ended: February	Sales	$ 875,318	$ 762,369
	Gross profit	265,704	231,609
	Net earnings	31,032	27,720
	Earnings per share	$ .51	$ .45
Quarter Ended: May	Sales	$ 792,645	$ 685,046
	Gross profit	242,349	211,918
	Net earnings	21,492	19,187
	Earnings per share	$ .35	$ .32
Quarter Ended: August	Sales	$ 778,817	$ 684,194
	Gross profit	246,237	215,055
	Net earnings	26,084	26,035
	Earnings per share	$ .42	$ .42
Fiscal Year Ended: August	Sales	$3,161,935	$2,744,625
	Gross profit	969,568	843,922
	Net earnings	94,169	85,446
	Earnings per share	$ 1.53	$ 1.39

Comments on Quarterly Results

In further explanation of and supplemental to the quarterly results, the 1985 fourth quarter LIFO adjustment was a credit of $2,010,000 ($.02 per share) versus a 1984 credit of $1,643,000 ($.01 per share). If the 1985 interim results were adjusted to reflect the actual inventory inflation rates and inventory levels at August 31, 1985, earnings per share for the first three quarters of 1985 would have been higher by $.02, $.01 and $.01 respectively, and the fourth quarter lower by $.04. Similar adjustments in 1984 would have increased earnings per share in the first three quarters by $.01, $.02 and $.01 respectively, and decreased the fourth quarter by $.04.

Fourth quarter earnings in 1984 also included a gain of $3,598,000 ($.06 per share) from the sale of the Company's 46.9% equity interest in its Mexican affiliate, Sanborn Hermanos, S.A.

Per share data have been adjusted for a two-for-one stock split effective in April of 1985.

Walgreen Co. Retail Report

Retail Unit Review

	1985	1984	1983	1982	1981
Drugstores					
Openings					
New Stores	95	72	61	67	68
Acquisitions	11	0	6	4	32
Major Remodelings	61	46	55	32	63
Closings	13	11	9	9	18
Year End: Units	1,095	1,002	941	883	821
Year End: Sales Area†	10,010	9,002	8,402	7,815	7,209
Separate Restaurants					
Openings	9	7	12	12	12
Closings	0	2	1	0	1
Year End: Units	94	85	80	69	57
Year End: Sales Area†	209	191	197	180	157
In-Store Restaurants					
Openings	0	0	0	1	0
Closings	32	13	25	30	29
Year End: Units	87	119	132	157	186
Year End: Sales Area†	184	243	274	329	377

†In thousands of square feet

Sales Review by Geographical Area

Chicago and Suburbs	21%
Other Midwest locations	22
Southwest	19
South and Southeast	26
West	10
East	2

Product Class Sales

	1985	1984	1983	1982	1981
Prescription Drugs	20%	18%	17%	16%	15%
Proprietary Drugs*	13	13	13	13	13
Cosmetics, Toiletries*	11	12	12	12	10
General Merchandise*	32	32	32	33	34
Tobacco Products*	6	6	6	6	7
Liquor, Beverages	14	14	15	15	15
Food Services	4	5	5	5	6

**Estimates based, in part, on periodic sampling of about 10% of retail units.*

Board of Directors

Directors

Fred F. Canning
President and
Chief Operating Officer
Elected 1977

Walter E. Cohen*
Former Vice President and
Director of Pay Less Drug
Stores of New Mexico
(acquired 1967)
Elected 1973

Charles D. Hunter
Executive Vice President
and Chief Financial Officer
Elected 1974

John E. Jeuck
Robert Law Professor of
Business Administration,
Graduate School of Business,
University of Chicago and
Business Consultant
Elected 1969

Mirrel R. Kephart
Former Senior Vice President
Elected 1971

William C. Musham*
Chairman, Gear Inc.
Elected 1978

Arthur C. Nielsen, Jr.
Former Chairman of the Board
and Chief Executive Officer
A.C. Nielsen Company
Elected 1969

John B. Schwemm
Chairman and President
R.R. Donnelley & Sons Company
Elected 1985

Charles R. Walgreen III
Chairman of the Board and
Chief Executive Officer
Elected 1963

Committees

Executive Committee
Charles R. Walgreen III,
Chairman
Fred F. Canning
Walter E. Cohen
Charles D. Hunter
John E. Jeuck

Audit Committee
William C. Musham,
Chairman
John E. Jeuck
Arthur C. Nielsen, Jr.

Compensation Committee
Arthur C. Nielsen, Jr.,
Chairman
William C. Musham
John B. Schwemm

Finance Committee
Charles D. Hunter,
Chairman
Fred F. Canning
Mirrel R. Kephart
John B. Schwemm
Charles R. Walgreen III

Nominating Committee
John B. Schwemm,
Chairman
John E. Jeuck
William C. Musham
Arthur C. Nielsen, Jr.
Charles R. Walgreen III
ex officio

Retiring in January, 1986

Officers

Corporate

Chairman of the Board
Charles R. Walgreen III,
Chief Executive Officer

President
Fred F. Canning,
Chief Operating Officer

Executive Vice President
Charles D. Hunter,
Chief Financial Officer

Senior Vice Presidents
John R. Brown,
Distribution and
Manufacturing
Vernon A. Brunner,
Marketing
L. Daniel Jorndt,
Treasurer
Glenn S. Kraiss,
Drug Store Operations

Vice Presidents
L. Alan Crotty,
Administration
John A. Rubino,
Human Resources
John B. Seastone,
Food Services
William O. Shank,
General Counsel,
Corporate Secretary
William A. Shiel,
Facilities Development

Controller
Roger L. Polark

General Auditor
Roger H. Clausen

Assistant Secretaries
Emily Koulogeorge
Joel H. Levin
Julian A. Oettinger

Assistant Controllers
Rudolph J. Macejak
John F. Richter
Raymond W. Wirsing

Assistant Treasurers
Richard C. Hildebrandt
John M. Palizza

Divisional

Drug Store Division

Regional Vice Presidents
Robert C. Atlas
Eddie L. Cudworth
Robert A. Daniels
W. Lynn Earnest
George C. Eilers
Jerome B. Karlin
Richard L. Moyer

Vice President
William G. Thien,
Health Services

Controller
John F. Richter,
Drug and Food
Accounting

Shareholder Information

Shareholder Communications
Please address any inquiries or comments to:
Shareholder Relations,
Walgreen Co.
The Company's annual report to the Securities and Exchange Commission, Form 10-K, may be obtained by any shareholder, free of charge, upon written request.

Corporate Headquarters
Walgreen Co.
200 Wilmot Road
Deerfield, Illinois 60015
(312) 940-2500

Transfer Agents
The First National Bank of Chicago
Suite 0134
Stock Transfer Dept.
Chicago, IL 60670

Morgan Guaranty Trust Company
Stock Transfer Dept.
30 W. Broadway
New York, NY 10015

Registrars
Harris Trust and Savings Bank
Chicago

Morgan Guaranty Trust Company
New York

Stock Market Listings
New York Stock Exchange
Midwest Stock Exchange
Symbol: WAG

Investor Contacts
L. Daniel Jorndt
John M. Palizza

Annual Shareholders' Meeting
You are cordially invited to attend the meeting to be held Wednesday, January 8, 1986, 2:00 p.m. in the Auditorium (8th floor) of the Harris Trust and Savings Bank, Monroe at LaSalle, Chicago, Illinois. (Formal notice of the meeting, with proxy card and proxy statement, will be mailed to all shareholders of record at November 12, 1985.)

Dividend Payment Dates
March, June, September, December. Checks are customarily mailed on approximately the 12th of each of these months.

Dividend Reinvestment Plan
Automatic Dividend Reinvestment (with cash investment option) enables Walgreen shareholders to authorize that dividend payments be used to purchase additional Walgreen stock. Purchase expenses are Company-paid. Withdrawal is optional at any time. For information booklet and authorization form, please write to: Shareholder Relations, Walgreen Co.

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Walgreen Co.
200 Wilmot Road
Deerfield, Illinois 60015